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# Supreme Court of the United States

**OCTOBER TERM, 1945.**

**NO. 263.**

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

## BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

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## OPINION OF THE COURT BELOW.

The opinion of the United States Circuit Court of Appeals for the Third Circuit is reported in 149 F. 2d, 232 and appears in the record at R. 68-71. The opinion as reported and as printed in the record includes the dissenting opinion of District Judge Fake. (R. 71-78).

The opinion of the Tax Court of the United States is reported in 3 T. C. 540 and appears in the record at R. 62-66.

## JURISDICTIONAL GROUNDS.

The decision of the Circuit Court of Appeals was entered on April 11, 1945. A petition for rehearing was filed April 25, 1945. An order denying rehearing was entered May 28, 1945. A petition for Writ of Certiorari was thereafter filed on July 26, 1945 and said petition was granted by your Honorable Court October 8, 1945. Jurisdiction of the Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938 U.S.C.A. Title 28, Section 347.

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## STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations herein involved may be found in the Appendix, *infra*, at pages 46 to 47.

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## STATEMENT OF CASE.

This case comes into this Court on writ of certiorari to the Circuit Court of Appeals for the Third Circuit to review the decision and order of said court affirming a decision of the Tax Court of the United States. The Tax Court, on petition for re-determination of a proposed deficiency, approved the respondent's determination that no bona fide partnership existed between petitioner and his wife in 1940 and held that all the profits of the business were taxable to petitioner as his individual earnings (R. 62).

The record shows that petitioner, A. L. Lusthaus was married to Lillian C. Lusthaus in 1915 (R. 24a). Petitioner started in the furniture business at Uniontown, Pennsylvania in 1918 (R. 3) and in 1933 he com-

menced the operation of a retail furniture business known as "Household Furniture Company," originally with one store and later with a second store known as "Furniture Outlet" (R. 6). The business was operated as a sole proprietorship. In all years prior to 1940, petitioner's wife worked with her husband in the business, waited on trade, took cash and helped in whatever way she was needed (R. 25). This work was done without compensation (R. 25).

In June or July of 1939, petitioner consulted his attorney (R. 38) in regard to taking in his wife as a partner in his furniture business. Concurrently, he discussed the matter with his wife, Lillian C. Lusthaus (R. 25). It was agreed that petitioner would sell a one-half interest in the business to his wife and that a partnership agreement would be entered into by them as of January 1, 1940. As originally discussed, the partnership was to be effective as of July 1, 1939 and an agreement, similar to the one later executed by the parties, was prepared by the attorney (R. 38) but it was not executed or put into effect at that time on advice of the attorney and the accountant for the business that the change should be made as of January 1, 1940 (R. 39).

An outright gift to his wife of a one-half interest in the business was also discussed but, upon the attorney's advice, this plan was not carried out and it was decided that petitioner should make a gift of $50,000 to his wife and that she should buy the one-half interest, paying for it with the $50,000, the subject of the gift, and promissory notes to total the agreed consideration (R. 39).

It was agreed that petitioner should determine the book value of his business as of January 1, 1940 and sell his wife a one-half interest therein for an amount which

represented one-half of the book value of the physical assets and inventory as of that date, excluding good will and excluding $20,000 accumulated profits to be withdrawn by petitioner (R. 4).

Petitioner and his wife agreed to proceed on this basis and the attorney was instructed in the Fall of 1939 to prepare the necessary papers which were to become effective as of January 1, 1940. (R. 4). The actual preparation of these papers was delayed by reason of the illness of the attorney from December of 1939 through January of 1940 and thereafter by his absence in Mexico and was further delayed by the departure of petitioner and his wife for Florida a few days after the attorney's return to Uniontown (R. 40).

On January 1, 1940, the business was put on a partnership basis, thereafter conducted as such (R. 41). Partnership books were opened (R. 33, 34). Thereafter, the profits of the partnership were equally divided between the partners on the books of the firm. Individual capital investment accounts were set up for each partner (R. 34) and were thereafter maintained. There was reflected in these accounts each partner's share of profits and all withdrawals made by each of them. Litigation was conducted in the partnership name (R. 42). Dun & Bradstreet were notified concerning the partnership either during 1940 or in January, 1941 (R. 17).

The value of petitioner's business as of December 31, 1939 was ascertained from a statement made up by the accountants from the books of the business to be the sum of $230,507.62 (R. 33), without giving effect to the withdrawal of $20,000 by the petitioner (Exhibit 4, R. 55, 56).

On January 12, 1940, petitioner made a withdrawal of $20,000 in cash from the business thus reducing the

value of the business assets to $210,507.62 (Exhibit 4, R. 56).

From and after January 1, 1940, petitioner continued in general charge of the operation of the partnership business. His wife continued to do some work in the store as she had done in the past (R. 31). Both of them were away from the business for about six weeks during March and April, 1940. (R. 5).

On June 4, 1940, petitioner, as agreed, executed and delivered to his wife the bill of sale (Exhibit 4, R. 53, 54, 55), transferring to her an undivided one-half interest in the assets of the furniture business owned by him prior to January 1, 1940, the transfer of ownership to be effective as of January 1, 1940. The consideration recited was the sum of $105,253.81 or one-half of the value of the business assets.

On the same date, petitioner and his wife, as agreed, executed and acknowledged the partnership agreement (Exhibit 1, R. 48, 52), to take effect retroactively on January 1, 1940 (R. 48), wherein the value of the partnership assets is fixed at $210,507.62 and the contribution of each party to partnership capital is fixed at "one-half thereof" (R. 49).

On or about the same date, petitioner made an outright gift to his wife of $50,000 by his personal check (R. 4). Petitioner raised this amount of money in part by a loan of $20,000 from the Second National Bank of Uniontown (R. 13, 14) and in part from his personal funds, including the $20,000 which he had withdrawn from his business on January 12, 1940 (R. 14).

Petitioner filed a gift tax return for 1940 (R. 13), reporting thereon a gift to his wife as of January 1, 1940 of property of the value of $50,000 (R. 34).

On June 18, 1940, petitioner's wife gave petitioner her personal check for $50,253.81 (R. 8) on account of the purchase price of a one-half interest in his furniture business and, at the same time, she executed and delivered to petitioner a series of eleven promissory notes, each in the sum of $5,000 payable in one to eleven years, respectively (R. 9), to cover the unpaid balance.

As of the date of trial, the notes maturing in January, 1941, 1942 and 1943, together with the interest accruing thereon (R. 9) had been paid in full.

As of January 1, 1940 and June 4, 1940, petitioner's wife had a separate estate consisting of a dwelling valued at from $25,000 to $30,000 and securities valued at from $20,000 to $25,000 (R. 26). Petitioner's wife for a long time prior to the partnership had maintained a personal bank account in her own name (R. 26).

During 1940, the capital account of Lillian C. Lusthaus was charged with her withdrawals amounting to the sum of $59.61 and during 1941, the sum of $16,317.86. Petitioner's capital investment account was charged during 1940 with withdrawals amounting to $4,604.76 and during 1941 with the sum of $19,198.69 (Exhibit 16, R. 60, 61).

An application for registration, stating that petitioner and his wife were engaged in business under a fictitious name, was executed and sworn to by them and was filed with the Secretary of the Commonwealth of Pennsylvania and with the Prothonotary of the Court of Common Pleas of Fayette County in 1940 (R. 42). Certificates of Registration, authorizing the parties to operate under the fictitious name of "Household Furniture Company," were thereafter issued dated July 31, 1940. Similar certificates were issued to cover the store known as "Furniture Outlet Store" (R. 42, 43).

The partnership bank account was maintained in the Second National Bank, Uniontown, Pennsylvania (R. 19) under the name "Household Furniture Company." Prior to 1940, petitioner and his wife had maintained a joint bank account. Beginning with 1940, they opened separate accounts (R. 18). Petitioner neglected to authorize the bank to honor his wife's signature on checks against the partnership account until some time in 1943 (R. 19). It was not considered necessary that the bank have her signature since petitioner had full charge of the business and she was not called upon to sign any checks (R. 22).

Social security tax returns, prepared by the bookkeeper and submitted to the petitioner for signature (R. 23), were signed by the petitioner until 1941 as "owner" instead of "partner" (R. 20, 21). The designation was typed on by the bookkeeper (R. 21) who had full charge of the work (R. 20).

The income tax return of the business for the year 1940 was filed (R. 6) as a Partnership Return of Income (Form 1065) showing petitioner and his wife as the partners and one-half of the net profits of the business distributable to each of them (Exhibit 3, R. 52a-b).

Petitioner and his wife each filed an Individual Income and Defense Tax Return for the year 1940 (Form 1040) (R. 27) and included therein as received from the partnership one-half of the net income of the partnership business as shown on said partnership return.

The respondent, in examination of petitioner's income tax return for 1940 determined an income tax deficiency in the sum of $22,419.98, the principal and contested portion of which deficiency results from the inclusion in petitioner's gross income of all the profits of said business (R. 62). The respondent determined in

his deficiency notice that no bona fide partnership existed between petitioner and his wife in 1940 (R. 64).

The Tax Court, upon the pleadings and after hearing at Pittsburgh, Pennsylvania, September 20, 1943, affirmed the determination of the respondent. The court held that, in effect, the alleged partnership was not bona fide and said (R. 65):

> "The evidence here discloses another of those superficial arrangements whereby a husband undertakes to make his wife a partner in his business for the obvious, if not the sole, purpose of reducing his income taxes."

The decision of the Tax Court was appealed to the United States Circuit Court of Appeals for the Third Circuit and the said court, following argument and briefs, entered its opinion on April 11, 1945 (R. 68, 69 and 70) affirming the decision of the Tax Court. District Judge Fake, specially assigned to sit in the said case, filed a dissenting opinion (R. 71 to 78, inclusive). Judgment was entered on April 11, 1945.

Thereafter, petitioner filed a petition for rehearing in the Circuit Court of Appeals for the Third Circuit (R. 79-86). On May 28, 1945, said petition for rehearing was denied.

Thereafter, on July 26, 1945, petitioner filed in this court his petition for writ of certiorari to review the decision of the Circuit Court of Appeals and on October 28, 1945 an order was entered granting the writ.

## SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred;

(1) in holding that the conclusions and the decision of The Tax Court of the United States were supported by substantial evidence,

(2) in failing to hold that the decision of The Tax Court was not in accordance with law,

(3) in affirming the decision of The Tax Court.

## SUMMARY OF ARGUMENT.

The sole issue in this case is whether or not the partnership formed by Petitioner and his wife is bona fide. If the asserted partnership is bona fide, the partners are liable for income tax only in their individual capacity and each partner is required to return only his distributive share of the ordinary net income of the business. Sections 181 and 182 of the Internal Revenue Code (Appendix, Pages 46-47). These sections of the Code are controlling and are determinative of Petitioner's tax liability, unless it appear that

1. The action of the Petitioner and his wife in the formation of their partnership was fictitious and fraudulent in that they did not intend to be bound by the legal effect of their actions; or

2. The Petitioner in the alleged gift and sale of a partnership interest to his wife or in the conduct of the business under the partnership agreement retained such control and dominion that there was no substantial change in his economic interests in and control of the said business and its assets.

Petitioner and his wife formed a partnership for the conduct of a business in which capital was a material income producing factor, which was valid under local law. Certain well-defined individual property rights and liabilities were thereby created. Petitioner and his wife became the co-owners of the partnership business and of the specific partnership property holding as tenants in partnership. Each of them became jointly liable for all debts and obligations of the business. Their status and the property rights vested in each of them under local

law must be given recognition for income tax purposes, if they are actual and bona fide.

There are no facts in the record to justify the Tax Court's conclusion, that the partnership was not bona fide. The terms of the partnership agreement evidence good faith and reserve to the Petitioner no control or dominion over the property or income of his wife. The transactions entered into between the parties evidence good faith and there is no evidence in the record to justify the conclusion that Petitioner failed to vest in his wife all of the incidents and attributes of ownership of the business interest which he sold to her. The gift of cash made by Petitioner to his wife was upon a condition subsequent immediately performed which was not inconsistent with the vesting of full title and control in her. By use of the subject matter of her gift and by valid notes Petitioner's wife acquired the unrestricted and complete ownership of a one-half interest in his furniture business. This business interest the wife then contributed to the capital of the partnership which she immediately formed with her husband.

There is nothing in the evidence to justify the conclusion or finding that Petitioner's wife did not acquire a separate interest of her own or that Petitioner did not through the said gift and sale and agreement change his economic interests in the furniture business which he had theretofore individually owned.

If Petitioner's wife made an actual contribution to a partnership in which capital is essential in producing partnership profits and if Petitioner and his wife became associated to carry on the partnership business as co-owners, the issue presented by this case must be resolved

in Petitioner's favor. Respondent has determined that no partnership existed and that the asserted partnership was not bona fide and would not be recognized for income tax purposes. Upon a showing that a valid bona fide partnership did exist Petitioner has demonstrated that Respondent's determination is wrong and this is the sole burden imposed upon him by the law. A potential assignment of income as distinguished from the ownership of the corpus which produces income is not involved in this proceeding.

A partnership between a husband and wife gives rise to no presumption of fraud or bad faith. It is not the province of the Tax Court to undertake a revision or change of the taxing statutes. The separate economic interest of the Petitioner and of his wife are entitled to full recognition for income tax purposes.

The Tax Court's decision is not in accordance with law, its ultimate conclusion is a clear cut mistake of law and in any event, is wholly unsupported by any substantial evidence in the record. The issues presented do not come within the special competence of the Tax Court and are subject to review on appeal. The decision of the Circuit Court, affirming the Tax Court, should be reversed.

## ARGUMENT.

### I. If the Asserted Partnership Is Bona Fide, Petitioner Is Taxable Only on His Distributive Share of Partnership Profits.

The question presented in this case as stated in the opinion of the court below is "whether the asserted partnership of the taxpayer and his wife should be recognized for income tax purposes" (R. 68).

The specific issue involved is the bona fides character of certain property transfers and of certain contracts entered into between petitioner and his wife and of the conduct of the partnership business created thereby (R. 17). Did petitioner's wife make an actual contribution of capital to the partnership?

The facts are not in dispute. If the transactions in question were entered into and carried through legally and in good faith, their legal effect must prevail unless it appears that the substantial attributes of ownership are retained by petitioner. There is no provision in the Federal statutes and there is no principle of law under which complete and unrestricted ownership of property or a bona fide partnership status valid under local law can be ignored for income tax purposes.

Petitioner contends that he and his wife formed a valid partnership and, under the laws of the Commonwealth of Pennsylvania, each became the owner of a one-half interest in the business, including its assets. Their separate legal property interests and contract rights are defined by law. The business engaged in was one in which capital was the material income producing factor and, upon formation of the partnership, it con-

tinued to be operated and to function as a partnership business. Each partner owned a one-half interest in the business and its assets and each was was entitled to one-half of the profits of the business.

Under these circumstances the measure of each partner's individual liability for income tax on partnership profits is fixed by the provisions of the Internal Revenue Code, Sections 181 and 182 (Appendix pp. 46-47). These provisions of the Internal Revenue Code are controlling unless there is substantial evidence in the record to show:

1. That the petitioner and his wife acted in bad faith without actual intention of being bound by the legal effect of their actions and that their arrangements and transactions amount to fraud, actual or constructive, or

2. That petitioner, in the alleged gift and sale to his wife or in the conduct of the business under the partnership agreement, retained such dominion and control of the property contributed by his wife, that there was no substantial change in his economic interests in and ownership of the said business and its assets.

## II. Petitioner and His Wife Formed a Partnership Valid Under Local Law and Separate Property Rights Were Established Thereby.

It is apparently conceded that, under Pennsylvania law, a husband and wife may become business partners. (See *Northampton Brewery Corp. v. Laude*, 138 Pa. Sup. 235). The personal relationship of partners is of no consequence if their association is bona fide and an

actual contribution of capital or of services is made. Furthermore, the source of the contributions of capital which individual partners make to the capital of the firm is of no consequence if they, in fact, acquire and become the owners of actual partnership interests. In *Schuster v. Largman et al.*, 308 Pa. 520, 528, 164 Atl. 305, the Supreme Court of Pennsylvania said as follows:

> "The indispensable requisites of a partnership are co-ownership of a business and the sharing of its profits. * * * *The fundamental requisite of a partnership is co-ownership of a business.* * * * (Italics supplied)."

In *Meehan v. Valentine*, 145 U.S. 611, this court stated as follows:

> "The requisites of a partnership are that the parties must have joined together to carry on a trade or adventure for their common benefit, each contributing property or services, and having a community interest in the profits. *Ward v. Thompson*, 63 U.S. 22."

The evidentiary facts in this case, as found in the Tax Court, are not in dispute and it is apparently conceded that the partnership formed by the parties was a valid one in so far as the laws of the Commonwealth of Pennsylvania are concerned. It follows that the rights and liabilities attaching under Pennsylvania law came into being upon the formation of the partnership and affected the property and economic interest of petitioner and his wife accordingly.

The Uniform Partnership Act of Pennsylvania 1915, P.L. 18, as amended, P.S. Title 59 provides in part as follows:

"§11. *Partnership defined*

"(1) A partnership is an association of two or more persons to carry on as co-owners a business for profit."

"§13. *Partnership property*

"(1) All property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property."

Those parties who become members of a partnership, i.e., who become "co-owners" of a business, acquire a well defined legal status the incidents of which are those as established by law and by their agreement.

"§71. *Extent of property rights of partners*

The property rights of a partner are

"(1) His rights in specific partnership property.

"(2) His interest in the partnership, and

"(3) His right to participate in the management."

"§72. *Nature of partner's rights in specific partnership property*

"(1) A partner is co-owner with his partner of specific partnership property holding as a tenant in partnership."

"§73. *Nature of partner's interest in partnership*

"(1) A partner's interest in the partnership is his share of the profits and surplus and the same is partnership property."

"§37. *Nature of partner's liability*

"All partners are liable—

"(a) jointly and severally, for everything chargeable to the partnership under Sections 13 and 14*;

"(b) jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract."

It is self evident that under Pennsylvania law the petitioner and his wife as well, changed their economic interests in the business and its assets. New and different liabilities were assumed by each. Additional capital was made liable for the firm's debts since before entering into the partnership, and apart from the gift of $50,000 involved, petitioner's wife (R. 26) had a separate estate consisting of a dwelling house valued at $25,000 to $30,000 and of securities valued at from $20,000 to $25,000.

## III. Local Law Controls In Determining a Status or Relationship Made Expressly Subject to Federal Taxation.

We have heretofore pointed out that, under the law of Pennsylvania, the procedure followed by petitioner and his wife was legally sufficient to completely divest the petitioner of the ownership and of the control of the undivided one-half interest in the furniture business

* These sections relate to wrongful act or omission by a partner acting in the ordinary course of the business of the partnership and a breach of trust by a partner acting within the scope of his apparent authority.

which he had formerly owned in its entirety and that, in the formation of a partnership with his wife, her status as a partner and as a co-owner of the partnership business was legally established. If they acted in good faith and the petitioner retained no control or dominion over the corpus or the income of the property owned by his wife, they are subject to Federal tax as "partners."

This court said in *Poe v. Seaborn,* 282 U.S. 101, 110, as follows:

> "What then is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor? The answer is found in the statutes of the state and the decisions interpreting them."

In *Blair v. Commissioner,* 300 U.S. 5, 9, this court, referring to the validity of an assignment of income of a testamentary trust said as follows:

> "The question of the validity of the assignments is a question of local law. The donor was a resident of Illinois and his disposition of the property in that state was subject to its law. By that law, the character of the trust, the nature and extent of the interest of the beneficiary and the power of the beneficiary to assign the interest in whole or in part, are to be determined. The decision of the state court upon these questions is final."

(See also *Helvering v. Fuller,* 310 U.S. 69, 74; *Morgan v. Commissioner,* 309 U.S. 78, 82).

In the case of *Helvering v. Stuart,* 317 U.S. 154, 161, Mr. Justice Reed says:

> "When Congress fixes a tax on the possibility of * * * the distribution of income, the 'neces-

sary implication,' we think, is that the possibility is to be determined by the state law. * * * Congress has selected an event * * * and has directed a tax to be levied if that event may occur. Whether that event may or may not occur, depends upon the interpretation placed upon the terms of the instrument by state law. *Once rights are obtained by local law, whatever they may be called, these rights are subject to the Federal definition of taxability.* (Italics supplied)."

## IV. The Terms of the Agreement and the Acts of the Parties Evidence Good Faith and Petitioner's Lack of Control Over the Property and Income of His Wife.

The agreement of partnership executed by Petitioner and his wife is in evidence, (Exhibit No. 1, R. 48-52) it clearly recites the joint ownership of the parties of the retail furniture business in question and the contribution by each of them of their undivided one-half interest therein to be and to constitute the assets of the partnership. Throughout the entire agreement, the capital contribution and the one-half ownership of each partner is clearly and consistently recognized. The provisions of the agreement, fixing the respective capital interests and investments of the parties and their right to participate in the profits of the business are completely mutual. It is expressly provided in Article 8 of the agreement (R. 50) that "profits may be withdrawn by the partners at such times as both agree that said withdrawals may be made without injury to the welfare and expansion of the business."

The agreement also contains provisions relative to the purchase of the interest of a deceased partner and to the rights of the partners in event of dissolution or liquidation. Here, again, petitioner is given no greater rights and assumes no greater liabilities than does his wife.

The operation of the business, as distinguished from the distribution of its profits and the disposition of the capital interests or investments of the partners, is covered by Article 6 of the agreement which provides as follows (R. 49):

> "6. It is understood and agreed that the said ABRAHAM L. LUSTHAUS shall have full charge of the operation of all of the business of said partnership and shall act as Manager thereof, with full power to employ and discharge such persons as he may think advisable and necessary in the proper conduct of said business. In all matters in connection with the operation and management of said business the said ABRAHAM L. LUSTHAUS shall be in full control and shall have the final decision."

It should be noted that the above provision relates solely to the *operation and management of the business* of the partnership and confers on the petitioner absolutely no rights or preferences in so far as the distribution of profits or the disposition of capital investment is concerned. The appointment of a managing partner is not only proper but customary.

The power granted to petitioner as managing partner established nothing more than an agency relation; it did not make him the "owner" of the partnership interest or share of partnership income which belonged to his wife individually.

It is an accepted principle of law that power of management of a trust retained by the grantor, does not operate to bring the grantor of such power within the provision of the Internal Revenue Code, Section 22(a) (26 U.S.C. 669) (Appendix pp. 46-47) if by such power the *grantor derives no economic benefit. Jones v. Norris,* 122 F. (2d) 6. *Commissioner v. Branch,* 141 F. (2d) 985; *Commissoner v. Katz,* 139 F. (2d) 107. This principle applies with even greater force to the delegation of the power of management of a business to an agent who derives no preferential benefit therefrom.

The Tax Court refused to accept petitioner's status as a partner and to recognize, for income tax purposes, the partnership formed by petitioner and his wife. The effect of the decision is to deny that petitioner's wife became the owner of the property which she contributed to the partnership capital. The necessary implication is that all the things done by petitioner and his wife in the formation and subsequent conduct of the partnership business were merely superficial gestures not intended to be legally effective or to change petitioner's economic interests in the property and business initially owned and conducted by him. It is important, therefore, to examine in detail exactly what the parties actually did and what steps were taken by them to the end that a partnership might be established. The steps taken are well summarized by Judge Fake in his dissenting opinion filed in this case in the court below, (R. 71-73) as follows:

> "(1) The value of petitioner's business was ascertained from a statement made up from the books of the business and fixed at $230,507.62, as of January, 1940.

"(2) On January 12, 1940, petitioner withdrew $20,000 in cash from the business, thus reducing the value of the assets to $210,507.62.

"(3) On June 4, 1940, a partnership agreement was entered into between petitioner and his wife, taking effect retroactively on January 1, 1940, wherein the value of the assets is fixed at $210,507.62, because of the withdrawal of $20,000 as above mentioned.

"(4) On the same day, to wit, June 4, 1940, the petitioner executed and delivered to his wife a bill of sale transferring to her an undivided one-half interest of, in and to the assets of the business in consideration of the sum of $105,253.81.

"(5) Petitioner made his wife a present of $50,000, evidenced by his check, to be applied by her to the purchase price above mentioned and paid a gift tax thereon.

"(6) The wife gave petitioner her personal check for $50,253.81 to be applied on the purchase price, and executed and delivered to petitioner a series of eleven promissory notes each in the sum of $5,000 payable in one to eleven years, respectively, thus accounting for the full purchase price, and these notes have been paid as they matured.

"(7) The business is that of buying and selling household furniture, carried on in two stores, one known as Household Furniture Company and the other as Furniture Outlet Store, both in Uniontown, Pennsylvania.

"(8) Certificates to transact business as partners under these assumed or fictitious names were

duly filed in the Office of the Secretary of the Commonwealth and in the Office of the Prothonotary of Fayette County, pursuant to Pennsylvania law.

"(9) As of January 1, 1940, partnership books were opened and thereafter the profits of the partnership were equally divided between the partners on the books of the firm, and each partner thereafter made withdrawals therefrom, making deposits in their respective individual accounts.

"(10) The wife had a separate estate consisting of a dwelling valued at from $25,000 to $30,000 and securities valued at from $20,000 to $25,000 before and at the time she entered into the partnership.

"(11) Before the wife entered into the partnership she had for years helped out in the stores and after the partnership she functioned in like manner.

"(12) The bank with which the partnership had its account was not authorized to accept checks of the wife as a partner until 1943.

"(13) Social Security tax returns were filed after the partnership until 1941, reciting petitioner as owner.

"(14) The income tax return for the year 1940 was filed as a partnership return.

"(15) The partners instituted law suits in the partnership name." (R. 71-73).

In the majority opinion of the court below, it is suggested (R. 70) that the fact that the bank with which the partnership had its account was not expressly

notified to accept Mrs. Lusthaus' signature as a partner with authority to draw checks until 1943 "tends to justify" the decision of the Tax Court and that social security tax returns were filed, up until June, 1941, carrying petitioner's signature as "owner" rather than as "partner" would have the same effect. If these matters are actually considered of any substantial importance, it is of equal importance that petitioner testified (R. 22) that the failure to file his wife's signature with the bank *was a mere "oversight"* and that, since he had full charge of the business activities, there was no necessity or occasion for her to sign any checks. Petitioner testified with respect to the social security returns (R. 21) that this work was done by a bookkeeper upon whom he relied and that he signed these returns without examining their contents.

Petitioner submits that the significance of these matters, if they have any, lies in the fact that they are *omissions naturally occurring in the transition of the business from a sole proprietorship to a partnership.* Undoubtedly a number of other details were also overlooked. The very lack of completeness in the immediate correction of all business methods and procedure to the partnership basis negatives the existence of the planned subterfuge charged by the Tax Court and attests the genuineness and normalcy of the partnership operations. It is difficult to conceive that evidence of this type should be given any weight whatsoever in support of a charge of bad faith or lack of substance and reality in the property transfers and legally binding contracts upon which the partnership is founded. Petitioner submits that such trivialities fall far short of the accepted standard reaffirmed in *Commissioner v. Scottish American Co.*, 323

U.S. 119, 124 where Mr. Justice Murphy speaking for a unanimous court said:

> "When the Tax Court's factual inferences and conclusions are determinative of compliance with statutory requirements, the appellate courts are limited to a determination of whether they have any *substantial basis in the evidence.* * * * If a substantial basis is lacking, the appellate court may then indulge in making its own inferences and conclusions or it may remand the case to the Tax Court for further appropriate proceedings." (Italics supplied)

We have heretofore attempted to set out in chronological order exactly what petitioner and his wife did prior to and following the formation of their partnership. (pp. 2-8). It is impossible for petitioner to understand what further the parties could or should have done to more completely evidence the sincerity of their purpose which obviously was to create and conduct a business partnership in which they would be the joint owners and the profits of which they would equally divide for all purposes.

The attorney for the parties testified personally in this case and gave a clear-cut statement of the negotiations and conferences held with petitioner and his wife relative to formation of the partnership. He recited (R. 40-41) that he had first prepared a partnership agreement some time in the Fall of 1939 and gave the reasons why execution of the agreement was delayed so that the partnership should become effective January 1, 1940. He explained the delay incident to the actual execution of the agreement, occasioned first, by his illness and absence from the city and, later, by the absence of peti-

tioner and his wife. He further gives his personal observation of the manner in which the business of the partnership was conducted during 1940. It appears from the evidence (R. 42-43) that the proper certificates authorizing petitioner and his wife to carry on business under the Fictitious Names Act of the Commonwealth of Pennsylvania were executed by the petitioner and by his wife and were filed by their said attorney on or about July 31, 1940. The attorney attributes the delay in filing these certificates to the general delay and difficulties which he encountered in connection with getting the matter closed. (R. 43).

It is not contended that the filing under the Fictitious Names Act is necessarily conclusive proof of the validity of the partnership association. Petitioner submits, however, that it is strongly indicative of the intention of the partners to publicly confirm and recognize the changed economic status and ownership of the business that resulted upon the formation of their partnership. The Fictitious Names Act (Act of Assembly of the Commonwealth of Pennsylvania of June 28, 1917, P. L. 18, as amended), provides in part that no individual or individuals shall carry on or conduct any business in the Commonwealth of Pennsylvania under any assumed or fictitious name, style or designation unless such person or persons shall after advertisement, file a certificate in the Office of the Secretary of the Commonwealth and of the Prothonotary, setting forth the names and addresses of the persons owning or interested in said business.

The Supreme Court of Pennsylvania in the case of *Rowland v. Canuso*, 329 Pa. 72, 79, referring to this Act of Assembly, said as follows:

> "The purpose of the Fictitious Names Act was to protect those who deal with persons carrying on a business under an assumed name, and to enable them to know with whom they do business; * * * it also serves the purpose of identifying those against whom, in certain circumstances, claims for damages arising from either tort or contract, should be made."

Compliance with the Act was an effective notice to all parties and to the world at large that petitioner and his wife were the owners of the two stores conducted under the names of "Household Furniture Company" and "Furniture Outlet Store." It is difficult to know upon what theory their personal liability to creditors could thereafter be avoided.

The instruments executed by the parties evidence no bad faith or lack of intention on their part to be bound thereby. The terms of the partnership agreement evidence no retention of control by petitioner over the capital investment of his partner; it furnishes him no greater rights with respect thereto than does any normal partnership agreement. There is nothing in the agreement that prevents either party from withdrawing from the partnership and the conditions of withdrawal are entirely mutual. The property rights of each partner are fully protected and consistently recognized. The partnership business was conducted as such and the books of account were so maintained. (R. 7). Litigation was instituted in the partnership name (R. 41) and in all major respects the transition from sole proprietorship to a partnership was consistently carried through.

A business relationship is nonetheless valid because the parties are husband and wife and the "close scrutiny" which family partnerships quite properly receive, raises no presumption of fraud or bad faith or lack of reality. Petitioner submits that the "bona fides" of the transactions in question are unchallenged by any testimony in the record.

## V. The Gift to Petitioner's Wife Was Complete and She Made an Actual Contribution to Partnership Capital.

It is frequently stated that a prerequisite to the formation of a valid partnership is the actual contribution of capital or services. However, such contribution must be "actual" only in the sense that complete ownership of a property interest results and is vested in the contributor. The source of a contribution to a partnership is of no importance if actual "co-ownership" of a business for profit results.

Petitioner submits that, in the instant case, he made a valid and complete gift of $50,000 to his wife vesting complete ownership in her and that she, in turn used this money as part of the consideration for the purchase from him of an undivided interest in his business. Petitioner asserts that this constitutes an actual contribution of her separately owned property to the partnership and that thus she became a co-owner with him in the conduct of a business for profit. The opinion of the Tax Court states that by "turning back" the gift given to the wife "conditionally" she acquired no "separate interest of her own" in the business. (R. 65) The implication is that

the wife owned nothing and, therefore, contributed nothing.

Such conclusion can be reached only by disregarding the realities of the case as well as the applicable principles of law. It is, in essence, a legal conclusion involving the common law rules of property. This is a field in which the Tax Court has no special province. It is not in that class of issues which is peculiarly within the competence of the Tax Court. The conclusion reached by the Tax Court is not "in accordance with law." It is a "clear-cut mistake of law."

A clear intention on the part of a donor to irrevocably divest himself of title and of dominion and control over the entire gift is fully recognized as one of the essential elements of a gift *inter vivos*. However, it is equally fundamental and a well recognized principle of law that a gift *inter vivos* does not become invalid or incomplete and that no incidents of ownership are retained by the donor when there is attached to the gift a condition which is not inconsistent with the prompt and complete vesting of unrestricted control in the donee. (See C. J. S., Vol. 38, Gifts, Sections 36, 37.) A gift of money to a wife or to a son or to a third party upon condition that it be invested to purchase a designated security is obviously nothing more in essence than a gift of the security itself. No possibility of reversion is occasioned by such a condition and no control or dominion is imposed which in any way affects or restricts the normal incidents of ownership. *Edson v. Lucas*, 40 Fed. (2) 398. *Beaumont v. Beaumont*, 152 Fed. 55.

On analysis, what actually occurred in the instant case was in essence the gift to petitioner's wife of an

undivided interest in the assets of his business to the extent of $50,000, a full one-half interest therein being valued at $105,000. It is submitted that the property rights of the parties were definitely changed by operation of law. The petitioner's wealth was decreased by $50,000 and petitioner's wife became the unrestricted owner of a partnership interest and her estate was increased accordingly. Concurrent execution of the partnership agreement evidences her contribution of said assets to the partnership capital.

## VI. The Separate Economic Interests Created by the Transactions Involved Must Be Recognized for Income Tax Purposes.

From the opinion and decision of the Tax Court, it is self-evident that the court approached and examined the facts of record as though under some compulsion to attach to all transactions between Petitioner and his wife a lack of reality almost equal to a presumption of fraud and bad faith. We feel quite sure that this court did not intend that the doctrine announced in *Helvering v. Clifford*, 309 U. S. 5 should have such interpretation.

The essence of the Clifford decision in so far as it is applicable in the instant case is that a legally perfect gift of income producing property will not *necessarily* relieve the donor of tax liability on the income therefrom in a case where the transfer is a temporary intra-family arrangement and the transferor reserves to himself such a bundle of rights and incidents of control over both the corpus and the income of the gift that his economic position has not been changed and he remains in substance the true owner thereof. There lacks in the

instant case any semblance of control, either over the wife's capital investment, her property, or over her share of the partnership income. The sole similarity in the cases is that a husband and wife relationship is involved in each.

The accepted principle that taxation is a practical matter in which substance controls over form is not intended to grant permission to the courts to supplement and enlarge the provisions of the Federal revenue acts in order to prevent methods of tax reduction which Congress itself has not seen fit to correct. The principle still remains unchallenged that a taxpayer may, by lawful means, minimize his taxes. The intention to reduce taxes is under no circumstances to be considered as bad faith. *Gregory v. Helvering,* 293 U.S. 465. We do not understand that *Helvering v. Clifford, supra,* was intended to encourage or to permit the principles there announced to become a substitute for legislation which Congress has refused to enact or for regulations and procedure which the Respondent has so far refused to adopt.

Granting that the present provisions of the Internal Revenue Code which require recognition of a family partnership grounded on a bona fide, completed gift and a legal partnership agreement might be subject to abuse and may, when abused, open the door to tax avoidance, it is still not the province of the Tax Court or of the appellate court to close the door by arbitrary factual conclusions or by erroneous legal conclusions. The courts have no power to legislate. If Congress has permitted a gateway of avoidance, it is Congress that must close

the gate. The many bona fide family partnerships that exist should not be subjected to the penalty of non-recognition because of the possibility that fictitious and unreal partnerships may crowd through the same gate.

The Revenue Act of 1937, approved August 26, 1937 (59 Stat. 813; 26 U.S.C. 973) was captioned as "An act to provide revenue, equalize taxation, prevent tax evasion and avoidance and for other purposes." Prior to the passage of the Act, the President of the United States called to the attention of Congress certain methods of avoidance and evasion of tax liability brought to his attention by a letter from the Secretary of the Treasury. It was suggested that Congress enact legislation adequate to make the tax structure evasion proof. A letter from the Secretary of the Treasury to the President of the United States was directed to the attention of Congress. This letter listed eight separate and distinct methods alleged therein to be "devices employed by taxpayers for the purpose of defeating the income taxes which would be normally payable by them." (p. 1). Included in this list was the "device of husband and wife or father and children partnerships." (p. 3). Said letter also drew attention to the division of income between husband and wife in the community property states (Report of the Joint Committee of Tax Evasion and Avoidance, 75th Congress, First Session, House Document No. 337). These matters were referred to a Joint Committee of the Senate and House of Representatives of the United States and the report of said Committee was filed on August 5, 1937. This report is entirely silent on the subject of family partnerships although the other "devices" men-

tioned in said letter are commented upon. It made no suggestion on the subject of community property.

The Revenue Act of 1937, thereafter passed, left entirely unchanged all provisions relative to the taxation of family partnerships.

It is suggested that the fair inference from these facts, is that Congress was entirely satisfied with the then existing provisions for the taxation of partnership income. It is further suggested to your Honorable Court that Congress believed that any legislation attempting to ignore the common law rules of property between husband and wife would not only be invalid but would be highly discriminatory in view of the recognition afforded the division of income between husband and wife in the so-called community property states.

The fallaciousness of applying the rationale of the *Clifford* case to bona fide husband and wife partnerships is self-evident. The primary ground underlying the *Clifford* rule was that the donor in that case, by family relationship and by the terms of the instrument involved, retained the ability and right to recover the *subject matter of his gift.* Where, as in the instant case, the husband makes a bona fide, irrevocable and completed gift to his wife which she, forthwith, uses to acquire complete ownership of an interest in his business, the indispensable basis for attributing the partnership income to him is totally lacking because *he has lost all control, title and ownership to a part of the property which produces the income.*

Granting the possibility of benefits flowing to the husband indirectly from his wife by reason of the pre-

sumed entity of the family group there is, in the instant case, nothing further of any consequence whatsoever to add to the "bundle of rights" found in the *Clifford* case to evidence retention of the incidents of ownership. There exists no factual or legal basis for disputing the fact that, in the instant case, there was a definite and permanent change in the economic interests of the parties resultant upon their agreements and the legal, enforceable property and contract rights thereby established. The wealth of the petitioner was decreased by the gift which he made to his wife and the wealth of the wife was in turn increased. The separate estate of each of them was irrevocably changed and new and different liabilities were assumed, both by contract and by operation of law. Furthermore, the total assets of the partners, liable for partnership debts, were increased by her separate estate of more than $50,000. We venture to assert that the Respondent would be the first to assert upon the death of Petitioner's wife, that her estate includes for estate tax purposes, the one-half partnership interest here involved.

## VII. An Assignment of Income Is Not Involved in This Case.

In view of the mandatory provisions of the Internal Revenue Code (Sections 181 and 182) petitioner submits that he, individually, cannot be held taxable on *all* of the net income of the partnership without completely ignoring the recognized principle of *Blair v. Commissioner*, *supra*, and related cases holding that tax liability on income from property is based on "ownership."

In *Blair v. Commissioner, supra,* the court said as follows (p. 12):

> "In the instant case the tax is upon income as to which in the general application of the revenue acts, the tax liability attaches to ownership. See Poe v. Seaborn, supra, Hoeper v. Tax Commission, 284 U.S. 206, 52 S. Ct. 120, 76 L. Ed. 248."

*Lucas v. Earl,* 281 U.S. 111, *Burnet v. Leininger,* 285 U.S. 136, and the later decisions of *Helvering v. Horst,* 311 U.S. 112 and *Helvering v. Eubank,* 311 U.S. 122, are all assignment of income cases and do not purport to overrule the fundamental principles announced in *Blair v. Commissioner, supra.*

In *Pearce v. Commissioner,* 315 U.S. 543 the issue was whether or not a divorced wife should be subject to income tax in respect of an annuity purchased for her by her husband pursuant to a separation agreement. Mr. Justice Douglas said as follows:

> "Such cases as Helvering v. Horst, 311 US 112, 85 L ed 75, 61 S Ct 144; Helvering v. Eubank, 311 US 122, 85 L ed 81, 61 S Ct 149, and Harrison v. Schaffner, 312 US 579, 85 L ed 1055, 61 S Ct 759, supra, are not opposed to this result. Those cases dealt with situations where the taxpayer had made assignments of income from property. He was held taxable on the income assigned by reason of the principle 'that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach' of the Federal income tax law. Harrison v. Schaffner, supra (312 US p. 580, 85 L ed 1056, 61 S Ct 759). But in those cases the donor or grantor

had 'parted with no substantial interest in property' other than the specified payments of income.' Id. (312 US p. 583, 85 L ed 1058, 61 S Ct 759). *Here he has parted with the corpus.* And 'the tax is upon income as to which, in the general application of the revenue acts, the tax liability attached to ownership.' Blair v. Commissioner of Internal Revenue, 300 US 5, 12, 81 L ed 465, 470, 57 S Ct 330." (Italics supplied)

The Commissioner, in brief and in argument before the court below, asserted that, from a tax standpoint, the partnership between petitioner and his wife cannot be distinguished from an assignment of his income to her and cites the decisions of this court referred to above. Such argument fails to state under what principle of law it is permissible to completely ignore the capital investment of more than $200,000 which was the essential and primary factor in producing the partnership income.

The deficiency notice sent by Respondent to the Petitioner did not assert that the partnership agreement was an anticipatory assignment of income but, on the contrary, as found by the Tax Court (R. 64), Respondent determined in his deficiency notice that "no bona fide partnership existed between petitioner and his wife in 1940 and that petitioner is taxable on all the profits of his furniture business for that year." Quite obviously, it is the *validity of a partnership status that is at issue,* or, more fundamentally, the question presented is whether or not petitioner's wife became the actual owner of income producing property. If *she did become the owner of such property, Respondent's dis-*

*regard of her tax liability is necessarily erroneous and arbitrary.*

If it be conceded that petitioner and his wife formed a legal, valid partnership to which both contributed capital essential in the business, the issue here is resolved in Petitioner's favor. Even if the arrangement for profit distribution, gave to the wife a disproportionate share of the partnership earnings, it is nevertheless true that the Tax Court erred in ignoring the taxable status of the parties, and in holding Petitioner taxable on income from property owned by his wife.

The issue before the Tax Court was whether the Commissioner erred in totally disregarding the partnership status and in attributing all of its income to petitioner. There is no averment that all the income of the partnership was in fact the result of petitioner's personal services. There is no averment that the terms of the partnership agreement represented an assignment of petitioner's earnings to his wife. On the contrary, it is consistently recognized that some, if not a large portion, of the partnership income was a result of the capital invested. As a matter of common knowledge, capital is a large and material income producing factor in the conduct of the retail furniture business.

Under the principles of law which have been hereinbefore discussed and giving consideration to the character of the business in question and the fact that capital was the material income producing factor in the business, it necessarily follows that the Tax Court's finding, that all the business income is taxable to the petitioner, is a mistake of law and of fact.

The distinction between *personal service income* and *capital income* and the duty of attributing each type of income to the tree upon which it grew is no less conclusive because, in a given case, both are involved and one type of income is larger or smaller than the other. The assignment of income doctrine of *Burnet v. Leininger, supra,* only applies to income the initial right to receive and the beneficial enjoyment of which *vests in one person,* and is anticipatorily assigned or *diverted to another person.* Such income in the hands of the assignee is obviously derivative. Irrespective of the ratio existing between personal service income and capital income in any given case, *if capital is in any measure an income producing factor* and the parties have formed a valid partnership, it is beyond the province or right of the Tax Court, interpreting and administering the provisions of the Internal Revenue laws, to *arbitrarily disregard the basic principle that tax liability on income from capital is based upon ownership.*

If the Respondent desired to raise the issue that the terms of the partnership agreement fix a distribution of profits which is, to some extent, an assignment of Petitioner's earnings, and that some undisclosed part of the earnings from petitioner's labor are being enjoyed by the wife, he should have made such a finding. The Tax Court cannot, by indirection, restate or change the single issue here involved and place upon the taxpayer the burden of proving facts which are neither essential nor relevant to such issue. The Tax Court must apply the principles of law which are applicable to the issue presented and to the facts adduced by petitioner to support his position with respect thereto. The issue here is the existence of a partnership.

Petitioner has shown, beyond question, that he has such status and that it is bona fide. Petitioner has met the full burden imposed upon him by law; he has shown that the Respondent is necessarily wrong, in that some part of the partnership income is necessarily taxable to Petitioner's wife.

The following comments of this court in *Helvering v. Taylor*, 293 U. S. 507, are applicable:

> "We find nothing in the statutes, the rules of the board or our decisions that gives any support to the idea that the commissioner's determination shown to be without rational foundation and excessive will be enforced unless the taxpayer proves he owes nothing or, liable at all, shows the correct amount. While decisions o the lower courts may not be harmonious, our attention has not been called to any that persuasively supports the rule for which the commissioner here contends.
>
> "Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid. Lucas v. Structural Steel Co. 281 U. S. 264, 271, 74 L. Ed. 848, 852, 50 S. Ct. 263; Wickwire v. Reinecke, 275 U. S. 101, 105, 72 L. Ed. 184, 186, 48 S. Ct. 43; Welch v. Helvering, 290 U. S. 111, 115, 78 L. Ed. 212, 215, 54 S. Ct. 8. Frequently, if not quite generally, evidence adequate to overthrow the commissioner's finding is also sufficient to show the correct amount, if any, that is due. See e. g. Darcy v. Commissioner of Internal Revenue (C. C. A. 2d) 66 F. (2d) 581, 585. But, where as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is

bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him."

In any event, to attribute all of the partnership income to petitioner is necessarily an error of law on the facts as found. The Tax Court's conclusion and decision is in error irrespective of the issue presented so long as it stands unassailed that capital actually owned by petitioner's wife produced some part of the partnership profit.

## VIII. The Tax Court's Decision Is "Not in Accordance With Law," and the Decision of the Circuit Court Affirming It Should Be Reversed.

It was argued by the Respondent in the court below that the issues presented in this case should be included in those which, under the doctrine of *Dobson v. Commissioner,* 320 U. S. 49, are peculiarly within the competence of the Tax Court to resolve by reason of its specialized equipment and training and that the appellate court was not at liberty to substitute its own inferences and conclusions. Hence its decision must stand.

On the record it does not appear that the "mastery" in tax matters which has been attributed to the Tax Court has been displayed in the numerous cases involving family partnerships which have come before it for decision. It cannot be denied that numerous and conflicting theories have been advanced from time to time and that there is utter conflict in the decided cases, resulting in confusion to the taxpayer. In part, upon

this premise, it is urgently submitted that the problems of family partnerships are properly classified with those questions of constitutional adjudication, determination of local law questions and *common law rules of property* which are clearly "outside the special province of the Tax Court." *Trust u/w Mary Lily (Flager) Bingham, et al. v. Commissioner,* .... U. S. ...., 89 L. ed. advance opinions 1191.

The language of Mr. Justice Frankfurter in concurring opinion in the *Bingham case, supra,* is entirely applicable here (p. 12):

> "The interpretation of tax statutes and their application to particular circumstances are all matters peculiarly within the competence of the Tax Court. On the other hand, constitutional adjudication, determination of local law questions and *common law rules of property,* such as the meaning of a 'general power of appointment' or the application of the rules against perpetuities, are *outside the special province of the Tax Court.* See Paul, *Dobson v. Commissioner*: the Strange Ways of Law and Fact (1944) 57 Harv. L. Rev. 753, 847-48." (Italics supplied).

The reasoning implicit in the Tax Court's decision makes it entirely possible to "separate the elements" of the decision. Such process demonstrates that the main factor influencing the court was the *legally erroneous* conception, that the gift and sale were incomplete. This is a mistake of law.

Petitioner submits that the issue here involved is not within the range of questions as to which the Tax Court should have final say whether it be considered as a question "involving determination" of local law

questions and "common law rules of property" or as one involving the ordinary and accepted distinction between questions of law and questions of fact. Under either classification, it is reviewable. The majority opinion in *Trust u/w Mary Lily (Flager) Bingham, supra*, states as follows (p. 1195):

> "Hence, the statute *does not leave the Tax Court as the final arbiter of the issue whether its own decisions of questions of law are right or wrong.* That can only be ascertained upon resort to the prescribed appellate process by a consideration of the merits of the point of law involved and by its decision at the conclusion of the process, not before it begins. The fact that the Court of Appeals below, while accepting the Tax Court's findings of fact, has nevertheless reversed its decision, would seem not to leave the question of law decided so free from doubt that the mandate of the statute could rightly be disregarded on any theory." (Italics supplied)

In the same opinion, Chief Justice Stone says as follows (p. 1195):

> "Whether or not its decision is in accordance with law is a question which the statute, Int. Rev. Code, Article 1141(c)(1), expressly makes subject to review."

Petitioner, in the instant case, is not disputing the facts as found by the Tax Court to the extent that its findings are factual. It is the legal effect given to, and the legal conclusions based on admitted facts that are in issue. As we have heretofore pointed out, the whole structure of the Tax Court's reasoning is grounded upon a basic mistake of law and hence is built upon a false

foundation. It should be reversed. The court below was guilty of reversible error in accepting the erroneous legal conclusion of the Tax Court and in affirming the Tax Court's decision without substantial supporting evidince in the record. The court proceeded on the mistaken theory that such was its obligation and duty under the *Dobson* case, *supra.*

Petitioner further contends that, under the ruling of the *Dobson* case, *supra*; *Commissioner v. Scottish American Inv. Co., supra,* and other related decisions of this Court, the issue as to whether or not there exists any "substantial basis in the evidence" to support the factual inferences and conclusions of the Tax Court *is in itself a question of law.* The term "substantial evidence" or "adequate support in the evidence" has a generally accepted meaning. In *Edison Co. v. Labor Board,* 305 U.S. 175, 229 Mr. Chief Justice Hughes, speaking for the court, said:

> "We agree that the statute in providing that 'the findings of the Board as to the facts if supported by evidence, shall be conclusive' means supported by substantial evidence. * * * *Substantial evidence is more than a mere scintilla.* It *means such relevant evidence as a reasonable mind accepts as adequate to support a conclusion.*"

We are not intending to urge that the appellate court has the duty or right to weigh the evidence or to choose between conflicting inferences. We do most earnestly urge that it is the right and duty of the appellate courts to *identify scintilla evidence* and to make sure that factual findings or conclusions are grounded on evidence legally sufficient for such purpose. In the instant case

the sole evidence of control, aside from the alleged incompleteness of the gift because it was conditional, is the family relationship and one or two totally inconsequential details of operation which most naturally occurred.

It is submitted that this Court has not intended by its decisions to deprive the Appellate Court of the authority, on review, to discard an ultimate finding or conclusion which is without rational foundation and is reached in arbitrary disregard of the facts and the law. It is the duty and right of the Appellate Court to reverse a decision of the Tax Court which is grounded upon a mistake of law or upon factual findings for which there is no substantial supporting evidence in the record. The decision of the Tax Court in the instant case is not only grounded upon a basic mistake in the determination of a local law question and of common law rules of property (issues not within the special province of the Tax Court) but in addition is grounded upon factual conclusions which have no justification or support whatsoever in the record.

## IX. Conclusion.

The Internal Revenue Code provides that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity and that the net income of each shall include only his or her distributive share of partnershsip profits. The test of an individual's partnership status in the case in which the personal services rendered are not a factor is that such individual shall contribute to the partnership capital or otherwise become a co-owner with the other partners of a business conducted for profit. This is in substance, but a restatement of the basic principle of taxation, that the *actual owner* of income producing property is subject to tax on the income produced thereby.

Petitioner's wife became the *actual owner of income producing property* which she then contributed to the capital of the partnership business which she formed with her husband and thus became associated with him as co-owner of a business for profit. There is no basis in the evidence for a contrary conclusion. As a bona fide owner of an interest in the partnership, Petitioner's wife is taxable on her agreed share of the profits earned by the business and no issue involving the assignment of income is raised.

It is respectfully submitted that the Tax Court's conclusions that the Petitioner's wife acquired no separate interest of her own and that by the transactions in question there was no change in Petitioner's economic interest in the furniture business which he had theretofore owned individually are unsupported by any substantial evidence in the record and are clear-cut mistakes of

law. The issue upon which the Tax Court pronounced is one of local law and common law property rules, and is not one peculiarly within the competence of the Tax Court to resolve. The Tax Court's conclusion is not "allowable"; its decision is not in accordance with law and the decision of the Circuit Court affirming it should be reversed.

Respectfully submitted,

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*Of Counsel*:
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JOSEPH W. RAY, JR.

## APPENDIX.

### Statutes and Regulations Involved.

*Internal Revenue Code:*

Sec. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U.S.C. 1940 ed. sec. 22.)

Sec. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U.S.C. 1940 ed., Sec. 181.)

Sec. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U.S.C. 1940 ed., Sec. 182.)

Sec. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. (26 U.S.C. 1940 ed., Sec. 3797.)

# REPLY BRIEF ON BEHALF OF PETITIONER

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

## REPLY BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1945.

NO. 263.

A. L. LUSTHAUS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

## REPLY BRIEF ON BEHALF OF PETITIONER.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

1. *The primary conclusion underlying the Tax Court's decision is an erroneous legal conclusion. In affirming this decision the Circuit Court accepts this basic conclusion as correct. The Tax Court's decision is necessarily wrong because aside from such conclusion, it finds no "warrant in the record" nor a reasonable basis in the law.*

Respondent's Brief calls for this Reply Brief principally because the argument there presented completely abandons the line of reasoning followed by the Tax Court and approved by the Circuit Court. The Respondent nowhere discusses the basic theory upon which the Circuit Court of Appeals decided that "the Tax Court's conclusion to the effect that the alleged partnership was not

bona fide" was reasonable and should be affirmed. The Tax Court grounded its decision on the basic proposition that the gift of $50,000.00 to Petitioner's wife, followed by its immediate and required use by her in the purchase of an interest in his business, was not a completed gift because of such condition, that *consequently she owned nothing* and *made no contribution of capital to the partnership*. The Circuit Court held, on appeal, that (R. 70) *"it could be inferred"* from such circumstances (referring to the conditional gift) that the wife had made no real contribution and that Petitioner had not irrevocably divested himself of the subject matter of the gift.

Respondent apparently abandons the basis on which the Circuit Court affirmed the Tax Court and elects to rely on *Helvering v. Clifford*, 309 U.S. 331, as permitting the rejection for tax purposes of all intra-family transfers.

As to the record facts, other than those relating to the circumstances of the gift and purchase, the Circuit Court says (R. 70), "Other evidence not specifically set out in the Findings of Fact *tends to justify* the Tax Court's decision." (italics supplied) That there is evidence in the record which merely "tends" to justify the Tax Court's conclusion cannot be accepted as a substitute for the requirement of this Court that the inferences and conclusions of the Tax Court must have "substantial basis in the evidence". *Com. v. Scottish American Co.*, 323 U.S. 119.

It is quite clear that without the legally erroneous assumption made by the Tax Court as its basic premise, the record contains no evidence legally sufficient to support the Tax Court's decision. Granting that its basic

legal conclusion is an error of law, the Tax Court's decision, grounded thereon, cannot stand.

As a matter of fact, the Tax Court made no finding of retained control or of bad faith, nor does its opinion indicate that it considered such a finding would be justified except when grounded on the erroneous legal theory that the gift was incomplete and vested no separate estate in the wife because it was conditional.

The power to manage evidences no right to the economic benefits flowing from the property managed, and there is no evidence that Petitioner undertook to exercise dominion over his wife's business profits. Petitioner's wife states that she used her profits withdrawn (R. 27) "for whatever I need."

The record shows (Ex. No. 16, R. 61) that during 1941 the wife's account was charged with $7,410.36 to pay income and other taxes and that she withdrew in cash the sum of $8,907.50. Even granting that $5,000.00 of this amount was used by her to pay her note, which matured in January, 1941, there remains an excess of $3,907.50. These 1941 withdrawals are entirely relevant to the 1940 issue since they obviously represent a distribution of 1940 profits following the closing of the books. Petitioner's wife had and used a personal bank account (R. 27) and there is no evidence or ground for presumption that her husband had or exercised any control or dominion whatsoever over her funds.

Respondent repeatedly asserts the existence of Petitioner's control over the business and its profits and over the corpus of the property transferred by Petitioner to his wife, but he fails to point to any facts or cir-

cumstances such as a reasonable mind might accept as adequate to support such assertion.

2. *Capital was the material income-producing factor in the business here involved.* Respondent states on Page 21 of his brief, referring to the Petitioner, as follows: "* * * The income of the business was derived largely from his personal services and ability as manager * * *." Respondent's argument is in a large part grounded upon this incorrect statement and assumption. Numerous cases cited by Respondent relate to partnerships in which personal service was obviously the major income-producing factor. This type of case is clearly inapplicable.

The facts are that in 1940 the sales of the partnership business amounted to $276,325.62, the purchases amounted to $158,932.09, and the inventory at the close of the year amounted to $50,616.68. (See Exhibit No. 3, R. 52 a.) It also appears from Exhibit No. 3 that during 1940 the partnership received interest in the sum of $15,489.35. The balance sheet of January 1, 1940 (Ex. No. 9, R. 57) and the balance sheet of December 31, 1940 (Ex. No. 11, R. 58) show that as of the beginning of the year the business owned leases receivable in the sum of $195,161.01 and that as of the end of the year it owned leases receivable amounting to $228,240.72. This asset represents furniture sold on bailment lease, a customary practice in Pennsylvania, and it is clear on analysis of the exhibits that the $15,489.35 income item of "Interest" represents interest earned on outstanding bailment leases. The necessity of capital is further evidenced by the fact that the business expense in 1940 included rent in the amount of $11,265.00 and miscellane-

ous expense in the amount of $26,952.00. (See Ex. No. 3, R. 52 a.)

As to Petitioner's ability as manager of the business, there is nothing in the record to support the presumption that it contributed in any unusual manner to the business income. It does appear in the testimony that the Petitioner and his wife were both away from the business for nearly two months and that salaries paid to others in 1940 amounted to $42,372.17. (Ex. 3, R. 52 a.)

It follows that Respondent's statement that the business income was derived largely from Petitioner's personal service and his ability as a manager is wholly incorrect, and that his argument based thereon is without merit.

3. *The issue involved in this case is the existence or non-existence of a valid, bona fide partnership. If bona fide it must be recognized for tax purposes.* Respondent urges (Br. 7) that there is a duty on the Petitioner to do something more than to show that the Commissioner's determination is erroneous. Respondent argues that in the absence of proof of the *exact portion* of the business income which is attributable to the capital investment of Petitioner's wife in the business, the Tax Court committed no error in sustaining the Commissioner's determination that *all* income in dispute was taxable to Petitioner. The decision of this Court in *Helvering v. Taylor*, 293 U.S. 507, appears to fully discredit Respondent's argument. (See Petitioner's Br. p. 38.)

It is Petitioner's contention that proof of the incorrectness of the Commissioner's determination is, in

itself, sufficient to show such determination to be arbitrary, excessive, and unreasonable.

It is pertinent in this connection to know with some certainty the issue raised by the Commissioner in his "Notice of Deficiency." The Tax Court in its Findings of Fact (R. 64) states as follows: "The Respondent determined in his deficiency notice that no bona fide partnership existed between Petitioner and his wife in 1940 and that Petitioner is taxable on all of the profits from his furniture business for that year." A copy of the letter of notification of said deficiency and of the statement explaining the income adjustments made, appears hereafter in Appendix pages 8 to 15. The explanation given by the Commissioner for adjustment of Petitioner's income is as follows: (Appendix p. 14)

> "The income from partnership represented in your individual tax return has been eliminated inasmuch as it has been held that no partnership existed between you and your wife and that your income from business, as adjusted, set forth in Adjustment 'A' above, was taxable to yourself; * * *"

Thereafter, Petitioner filed his petition for a redetermination of the alleged deficiency in income tax and requested the Tax Court to find and adjudicate that he and his wife were partners and that only one-half of the income of the partnership was taxable to Petitioner. The case came to trial on the issue thus presented, to wit, the existence or non-existence of a bona fide partnership and the Tax Court, after hearing, concluded and held as follows (R. 66):

> "Whether or not the arrangement which Petitioner made with his wife constituted a valid partnership under the laws of Pennsylvania, we do not

think it should be given recognition for federal income tax purposes."

On appeal to the Circuit Court the decision of the Tax Court was affirmed in the following language (R. 71):

> "We cannot say here that the Tax Court's conclusion to the effect that the alleged partnership was not bona fide, is unreasonable. The decison of the Tax Court is, therefore, affirmed."

The actual issue here involved is thus clearly defined as the partnership *status*. The profit-sharing basis has not been challenged.

Respectfully submitted,

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NORMAN D. KELLER,
PAUL E. HUTCHINSON,
*Attorneys for Petitioner.*

*Of Counsel*:
REED, SMITH, SHAW & MCCLAY,
JOSEPH W. RAY, JR.

## APPENDIX.

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
2300 Farmers Bank Building,
Pittsburgh, Pennsylvania.
July 15, 1942.

OFFICE OF
Internal Revenue Agent in Charge
Pittsburgh Division

Mr. A. L. Lusthaus,
52 West Main Street,
Uniontown, Pennsylvania.

Sir:

You are advised that the determination of your income tax liability for the taxable year (x) 1940 discloses a deficiency of $22,419.98 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Pittsburgh, Penna., for the attention of IT:WPM-HIL. The signing and filing of this form will expedite the closing of your

return (x) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
*Commissioner,*

By
W. P. MAYS
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.
HIL/MM

STATEMENT

IT:WPM
HIL-90D

Mr. A. L. Lusthaus,
52 West Main Street,
Uniontown, Pennsylvania.

Tax Liability for the Taxable Year Ended December 31, 1940.

| | Liability | Assessed | Deficiency |
|---|---|---|---|
| Income tax | $30,946.58 | $8,526.60 | $ 22,419.98 |

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated October 30, 1941; to your protest dated April 17, 1942; and to the statements made at the conferences held on May 1, 1942 and June 23, 1942.

ADJUSTMENTS TO NET INCOME

| | | |
|---|---|---|
| Net income as disclosed by return | | $ 35,415.02 |
| Unallowable Deductions and Additional Income | | |
| (a) Income from business increased | $80,707.43 | |
| (b) Contributions adjusted | 568.00 | |
| (c) Other deductions adjusted | 2,600.00 | 83,875.43 |
| Total | | $119,290.45 |
| Nontaxable Income and Additional Deductions | | |
| (d) Income from partnership eliminated | | 40,140.00 |
| Net income as adjusted | | $ 79,150.45 |

EXPLANATION OF ADJUSTMENTS

(a) It has been determined that your income from business in 1940 amounted to $80,707.43 as explained in detail below, constituting the income during the entire calendar year 1940 from your business enterprises the Household Furniture Company and the Furniture Outlet Store. It has been determined that, under date of June 4, 1940, you and your wife, Mrs. Lillian C. Lusthaus, signed articles of agreement to associate yourselves as partners in the conduct of the business of the two enterprises mentioned above, in which articles of agreement reference was made to a bill of sale, also dated in June, 1940, but effective as of January 1, 1940, by which you sold and conveyed to your wife an undivided one-half

interest in and to said retail furniture and household furnishings businesses.

In consonance with this purported partnership organization you filed a partnership return of income, Form 1065, for the year 1940 in the name "Household Furniture Company", reporting thereon ordinary net income of $80,280.20 and under partners' shares of income, reporting $40,140.10 ordinary net income as the share of yourself and the same amount as the share of your wife.

Your claim that a partnership existed between you and your wife, Lillian C. Lusthaus, during the year 1940 has been denied.

Separate individual income and defense tax returns, Forms 1040, were filed by you and your wife on each of which individual returns $40,140.10, or one-half of the $80,280.20 ordinary net income on the partnership tax return, was reported in item 6, page 1, as income from partnership.

Inasmuch as it has been held that no partnership existed, the income that was reported on the tax return of the ostensible partnership, $80,280.20, as corrected by the several adjustments explained below to the adjusted amount of $80,707.43, has been determined to be your income from business, taxable to you and no part of which income is taxable to your wife, Lillian C. Lusthaus. In view of this decision, the amount of $40,140.00 reported by you as total income in item 12 of your tax return, has been eliminated by adjustment (d) explained below; in this connection the ten cent difference between the amount reported in item 6, $40,140.10, and the

amount reported as total income, $40,140.00, has been noted.

"Household Furniture Company"
An ostensible partnership, now held to have been the sole-proprietorship of Mr. A. L. Lusthaus.

ADJUSTMENTS TO NET INCOME

| | | | |
|---|---|---|---|
| Net income as disclosed by tax return for 1940, Form 1065, filed by this ostensible partnership | | | $80,280.20 |
| Unallowable Deductions and Additional Income | | | |
| (1) | Bad debts disallowed | $3,002.40 | |
| (2) | Legal fees disallowed | 1,160.82 | 4,163.22 |
| Total | | | $84,443.42 |
| Nontaxable income and Additional Deductions | | | |
| (3) | Donations and advertising expense allowed | $1,135.99 | |
| (4) | Additional compensation to employees | 2,600.00 | 3,735.99 |
| Net income adjusted | | | $80,707.43 |

It has been held that, in the absence of a partnership this net income adjusted constituted in its entirety, income taxable to you.

EXPLANATION OF ADJUSTMENTS

(1) The amount deducted as bad debts, $8,845.95, in item 20 of the tax return, Form 1065, has been allowed in the amount of $5,843.55, and disallowed in the amount of $3,002.40; the amount disallowed represented the ag-

gregate of small accounts receivable that were charged off the books but the worthlessness of which in 1940 had not been substantiated inasmuch as it was determined that substantial recoveries of portions of the accounts were being realized.

(2) The deduction of $1,160.82 legal fees has been disallowed inasmuch as said fees were paid for services relating to organization of the purported partnership and to the preparation of the Last Will and Testament of Lillian Lusthaus, deductions of this nature having been held to be unallowable.

(3) It has been held that the total of $1,135.99 for donations and for advertising, reported in detail in a schedule attached to the purported partnership return but not deducted in arriving at the ordinary net income reported on that return, constituted an allowable deduction against your income from business, in consequence of which said deduction has now been allowed as set forth above. As the result of this allowance, the one-half of $1,135.99, or $568.00, that you deducted as contributions in item 13, page 1, of your individual tax return has been disallowed by adjustment (b) following. In the tax return of the purported partnership, the $1,135.99 was reported in Column 10 of Schedule "J" as being deductible, one-half thereof by yourself and one-half by your wife.

(4) It has been determined that the amount of $2,600.00 additional compensation paid to certain of your employees constituted an allowable deduction against the income of your business; no part of that amount was deducted from the income reported in the tax return filed by the purported partnership. In consequence of the allowance of this $2,600.00 as a deduction from your

income from business, the same amount has been disallowed by adjustment (c), below, as other deductions on your individual tax return.

(b) The amount of $568.00 reported as a deduction for contributions in item 13, page 1, of your tax return, has been disallowed, inasmuch as this deduction constituted a part of the $1,135.99 that has been allowed in the foregoing adjustment (a), having been determined to constitute donations and advertising expense deductible against your income from business.

(c) The amount of $2,600.00 reported as a deduction for bonuses to employees in item 18, page 1, of your tax return, has been disallowed, inasmuch as this deduction has been allowed against your income from business, shown in the foregoing adjustment (a).

(d) The income from partnership reported in your individual income tax return has been eliminated, inasmuch as it has been held that no partnership existed between you and your wife and that your income from business as adjusted, set forth in adjustment (a), above, was taxable to yourself; the amount that you reported as income from partnership in item 6, page 1, of your tax return was $40,140.10; the amount that you reported in item 12, page 1, of your return, however, was only $40,140.00, in consequence of which the amount here eliminated is $40,140.00.

Personal exemption, $2,000.00, claimed by your wife on her tax return has been allowed as a deduction against her taxable income.

Credit for dependents in the amount of $800.00 has been allowed, no part of this credit having been claimed in your tax return; it has been determined that you actually supported two dependent children, in consequence

of which this credit has been allowed to you instead of to your wife who claimed this credit in her tax return.

The earned income credit $802.81, deducted in item 26, page 1, of your tax return has been increased by $597.19, as it has been determined that your corrected earned income credit was 10% of 20% of $80,707.43, your corrected income from business, but allowable only in the amount of $1,400.00.

COMPUTATION OF TAX

| | |
|---|---|
| Net income adjusted | $79,150.45 |
| Less: | |
| Credit for dependents | 800.00 |
| Balance (surtax net income) | $78,350.45 |
| Less: | |
| Earned income credit (10% of $14,000.00) | 1,400.00 |
| Net income subject to normal tax | $76,950.45 |
| Normal tax at 4% on $76,950.45 | $ 3,078.02 |
| Surtax on $78,350.45 (Amount in excess of $4,000.00) | 25,055.23 |
| Total tax (ordinary) | $28,133.25 |
| Defense tax (10% of $28,133.25) | 2,813.33 |
| Corrected tax liability | $30,946.58 |
| Income tax assessed: | |
| Original, account No. 205609 | 8,526.60 |
| Deficiency of income tax | $22,419.98 |

HIL/MMM